The 10b5-1 Plan:

WHAT EXECUTIVES NEED TO KNOW

The rules surrounding insider trading are among the trickiest for executives to navigate. One popular tool is the 10b5-1 plan, which can offer a safe way for executives to trade shares of their companies. Corporate Counsel Business Journal invited Jeff Cohen, Executive Vice President of AST Equity Plan Solutions, to interview industry insider Merrill Stone, partner at Kelley Drye & Warren LLP, in order to shed some light on how executives can use these plans securely and easily.

Jeff Cohen: Before we get into the details of a 10b5-1 plan, can you explain what Rule 10b5-1 says?

Merrill Stone: The SEC introduced Rule 10b5-1 in 2000. The rule was adopted pursuant to Section 10(b) of the Securities Exchange Act of 1934 and in connection with Rule 10b-5 thereunder, which, among other things, prohibits the trading of a company's shares on the basis of material insider information. Under the statute and rule, any directors, officers or other insiders who are in possession of material non-public information (MNPI) faces severe restrictions on their ability to sell or purchase securities issued by their company.

How does this relate to the 10b5-1 plan?

Rule 10b-5 serves as the basis for prosecuting nearly all insider trading violations. It can, however, also effectively restrict an insider's ability legitimately to manage his or her equity, which is increasingly becoming a key part of most executive compensation packages. Rule 10b5-1 established a straightforward way for insiders to trade safely—a safe harbor that has come to be known as the 10b5-1 plan. When used properly, the 10b5-1 plan can offer significant flexibility to executives who often acquire insider information, especially those seeking to liquidate some of their equity.

How does the 10b5-1 plan work?

The provision works like this: An "insider" seeking to sell or purchase shares in their company can adopt a written plan that essentially:

- Specifies the number of shares to be traded, along with the price and date of the purchase or sale; or

- Includes a written formula, algorithm or computer program for determining the number of shares to be traded and the price and the date of the trade; or

- Transfers trading authority to a third party not in possession of MNPI and prohibits the insider from exercising any subsequent influence over how, when or whether to make purchases or sales.

The 10b5-1 plan serves as an affirmative defense to insider trading. In other words, the SEC has stated that it generally views all trades that are made while a person has MNPI to be "on the basis" of that MNPI, and thus a violation of insider trading laws. However, if a trade is made pursuant to a 10b5-1 plan, the person has an affirmative defense that the trade was not made "on the basis" of the MNPI. On the other hand, if a person is in possession of MNPI and makes a trade that does not meet these requirements, the SEC will presume that trade to be illegal.

It is important to note that, at the time a person adopts a 10b5-1 plan, he or she must not be in possession of MNPI. But after the plan is in place, the person can acquire MNPI freely, and still have trades made through the 10b5-1 plan without fear of insider trading violations, because any information that is acquired cannot affect the pre-planned equity transaction. Rule 10b5-1 technically even allows one to terminate his or her plan on the basis of MNPI acquired after the fact, although as a practical matter many companies prohibit this in 10b5-1 plans involving their securities.

Do employers have any say in how employees use their 10b5-1 plan?

In most cases, yes. Before initiating a plan, employees should be sure to check with their employer to ensure that they are abiding by the company's relevant insider trading policies. While the basic requirements of Rule 10b5-1 are straightforward, it's common for issuers to impose their own restrictions for extra protection against insider trading and related risk management concerns. These restrictions often include placing limits on the number of shares that can be bought or sold, the frequency of trades, the minimum and maximum terms, whether trading outside the plan is permitted and whether modifications to the plan are permitted. Some issuers go as far as to mandate that all 10b5-1 plans adopted by employees be administered through a designated broker and pre-approved by the issuer. Others even prescribe the form of the plan that is to be adopted.

Most issuers also specify trading windows, which are periods of time during which employees are allowed to trade shares, and a "cooling off" period, which is the minimum length of time an insider must wait before the initial trade and between 10b5-1 trades, which can range from a few months to one or two years.

Above all, it is crucial when setting up a 10b5-1 plan for employees to double-check that they're complying with both federal regulations and company policies. While these may seem onerous at the time, they can protect employees from coming under unnecessary scrutiny later on. For those who have never been through an investigation with the SEC, let me put it this way: It's not fun. It's much better to be proactive and talk with a lawyer to make sure your plan is compliant!

If an executive wants to trade shares in their company, what's their first step to establishing a 10b5-1 plan?

To create a 10b5-1 plan, the first thing to do is check with the company to see what policies or other rules executives need to follow. Next, they should consult with their broker (or if required, the broker designated by the company) to set up a plan during an open window when the executive does not possess MNPI. Once the broker understands the parameters of the proposed trade, a legal team drafts the written component of the plan or adapts the company prescribed plan to meet the executive's parameters and submits it for approval by him or her, the broker and, in most cases, the issuer.

Once the plan is approved, the broker will execute the equity transaction(s) at the appointed date(s).

How common is it for executives to use a 10b5-1 plan?

More than 50 percent of S&P 500 companies have executives who utilize 10b5-1 plans. They are often used by executives who are hampered by their companies' trading blackouts, and they can help diversify a portfolio that is concentrated in a company's stock. A 10b5-1 plan can also serve as a safe and expedient way to pay off a tax bill or debt payment.

Are there different kinds of 10b5-1 plans to choose from?

There are many ways these plans can vary, but one of the main decisions to make is whether to use a market order or a limit order.

Market orders schedule the transaction at the market price at a certain date. Limit orders dictate that the transaction will only go through if the shares reach a certain price floor or ceiling. If a person wanted to liquidate his or her shares quickly, no matter the price, they'll typically use a market order. On the other hand, they can use a limit order to ensure a minimum return, but that also carries the risk of the transaction not proceeding if a condition—generally the price—is not reached.

What should our readers look for when choosing a broker to draw up their plan?

They should be sure to develop their 10b5-1 plan with a broker they trust. The right executive services team will know how to trade their specific company's stock, accounting for liquidity levels and the trading timeframe to secure the best pricing.

It is important that the broker understands the purpose for the trade, because this can dictate the details of the plan. An executive who is independently wealthy, for instance, will require a different strategy than one who is paying off student debt.

In cases where a company designates a single broker to handle all of its 10b5-1 plans, employees may benefit from the advantage of a single trading team being able to see the big picture and achieve the optimal outcome for all. In situations where multiple traders execute separately on behalf of multiple plans, they can sometimes end up competing with each other and lowering everyone's collective returns.

What's the most important take away about 10b5-1 plans?

The 10b5-1 plan offers a straightforward way for executives to manage their shares while retaining an affirmative defense against insider trading. With proper communication among the participant, the broker and the issuer, the plan can be a tool that lets employees make the most of their equity compensation benefits.

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